

STATE OF CALIFORNIA

SENATE SELECT COMMITTEE TO INVESTIGATE  
PRICE MANIPULATION OF THE WHOLESALE ENERGY MARKET

OVERVIEW OF INVESTIGATIONS, STUDIES, AND  
REPORTS REGARDING THE ENERGY CRISIS

PART V

STATE CAPITOL

ROOM 3191

SACRAMENTO, CALIFORNIA

THURSDAY, JUNE 14, 2001

1:18 P.M.

Reported by:

Evelyn J. Mizak  
Shorthand Reporter

APPEARANCES

MEMBERS PRESENT

SENATOR JOSEPH DUNN, Chair

SENATOR DEBRA BOWEN

SENATOR WES CHESBRO

SENATOR WILLIAM MORROW

MEMBERS ABSENT

SENATOR MARTHA ESCUTIA

SENATOR MAURICE JOHANNESSEN

SENATOR SHEILA KUEHL

SENATOR BYRON SHER

STAFF PRESENT

LARRY DRIVON, Special Council to Committee

DONNA DRIVON, Committee Technical Assistant

ALEXANDRA MONTGOMERY, Committee Consultant

RONDA PASCHAL, Committee Consultant

WADE TEASDALE, Chief of Staff to SENATOR MORROW

JUDYANNE MCGINLEY, Deputy Legislative Counsel  
Office of Legislative Counsel

ALSO PRESENT

CAROL COY, Deputy Executive Officer  
Engineering and Compliance  
South Coast Air Quality Management District

BARBARA BAIRD, District Counsel  
Office of District Counsel  
South Coast Air Quality Management District

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1 P-R-O-C-E-E-D-I-N-G-S

2 -- oo0oo--

3 CHAIRMAN DUNN: Welcome, everybody, to the  
4 fun-filled and action packed hearing of the Senate Select  
5 Investigative Committee.

6 I know I've said this before, and I'll actually  
7 try to adhere to it. We expect this hearing to be relatively  
8 short. Now, we can all engage in the definition of short. But  
9 we expect the testimony to be limited in its scope, and we're  
10 going to try to get to it as quickly as possible.

11 I know, Carol, I'm sure you're happy about that,  
12 so you can be in and out of here.

13 So, why don't we begin by calling our one and  
14 only witness this afternoon, Carol Coy. Carol, as you know,  
15 we've got to swear you in.

16 JudyAnne, if you would take care of the duties.

17 MS. MCGINLEY: I'm JudyAnne McGinley with  
18 Legislative Counsel.

19 Will the witness please raise your right hand and  
20 state your name for the record.

21 MS. COY: Carol Coy.

22 [Thereupon the witness,  
23 CAROL COY, swore to tell  
24 the truth, the whole truth,  
25 and nothing but the truth.]

26 MS. MCGINLEY: Thank you.

27 CHAIRMAN DUNN: Thank you, Ms. Coy.

28 While you're settling in there, I know that

1 you've got some prepared remarks as well.

2 What I'd like to do so before we get to those,  
Page 1

3 let's get a little bit of background for all of our purposes,  
4 although most of us are familiar with it, a little bit of the  
5 role of the South Coast Air Quality Management District.

6 But first, let's start with a little bit of your  
7 background, if you don't mind.

8 MS. COY: Certainly.

9 I'm the Deputy Executive Officer that's  
10 responsible for engineering and compliance activities at the  
11 South Coast District. I've been with the District over 19 years  
12 now and have a lot of experience in enforcement and hazardous  
13 materials. I basically started as an inspector and basically  
14 was promoted through the ranks.

15 CHAIRMAN DUNN: Share with us a description  
16 generally of your duties now in your current capacity.

17 MS. COY: Yes. I'm responsible for all of our  
18 inspectors' work in the field, all the field compliance  
19 activities, as well as all the permitting activities of the  
20 District, whereby we're issuing permits to all of the regulated  
21 businesses, as well as being responsible for oversight of  
22 compliance with the RECLAIM, Regional Clean Air Incentives  
23 Market, the RECLAIM Program and the federal Title 5 Program.

24 CHAIRMAN DUNN: Most of us have some familiarity,  
25 but for those that may be listening in and may not have really  
26 any detailed knowledge about the role of the South Coast Air  
27 Quality Management District, can you please explain what exactly  
28 it does?

1 MS. COY: Yes, certainly. I had planned to go  
2 ahead and --

3 CHAIRMAN DUNN: If that's part of your prepared  
4 text, why don't we roll right into your prepared text.

5 MS. COY: Good afternoon, Mr. Chairman, committee  
Page 2

6 members.

7 I'll refer to South Coast Air Quality Management  
8 District, by the way, as the AQMD in this testimony.

9 The AQMD is the regional agency that's  
10 responsible for air pollution control in the urban portions of  
11 Los Angeles, Orange, San Bernardino, and Riverside Counties,  
12 where nearly 15 million people breathe some of the most  
13 unhealthy air in the nation. To reduce air emissions to meet  
14 both state and federal clean air standards, we regulate about  
15 28,000 businesses, as well as a number of consumer products,  
16 such as water heaters, paint, and construction sites for  
17 fugitive dust.

18 I'm appearing in response to a committee  
19 consultant request that we testify regarding a specific  
20 emissions trade example that AQMD recently mentioned in FERC  
21 testimony. Before I explain the details of that specific  
22 transaction, though, I'd like to briefly describe the emissions  
23 trading market at the District.

24 As part of AQMD's state and federally approved  
25 plan for attaining the clean air goals for the region, AQMD has  
26 developed and implemented basically, at the business community's  
27 request, the largest market-based air pollution reduction  
28 program in the country. The program, known as the Regional

1 Clean Air Incentives Market, aka, RECLAIM, involves the 360  
2 largest emitters of Nitrogen Oxides, NOx, and Sulfur Oxides,  
3 SOx.

4 Since 1994, these industrial facilities have  
5 been regulated with facility-wide permits that have a declining  
6 annual allocation, annual emissions allocation, or a cap. This  
7 allocation basically parallels the actual emission reductions  
8 that would have been required by the command and control

9 regulations that the RECLAIM program replaced. The program  
10 allows the facilities great flexibility, as they're allowed to  
11 meet their declining allocation by installing control technology  
12 or by purchasing reclaimed trading credits, that I'll refer to  
13 as RTCs, from other companies in the market.

14 This program was designed to meet air quality  
15 improvement goals in the most cost effective manner possible.  
16 And indeed, participating companies have saved millions of  
17 dollars per year in compliance costs.

18 Now, basically, let's get to the question at  
19 hand.

20 As we've managed the RECLAIM program, AQMD staff  
21 has made a number of observations regarding the trading of these  
22 RTCs. Although we don't know all the reasons, we can present  
23 facts about what has happened.

24 One recent trend that the staff has been  
25 observing is the increased participation of third party  
26 marketers and holding companies. Third party transactions  
27 clearly increase RTC cost for program participants.

28 In one transaction, Pinnacle West Marketing and

1 Trading, an energy corporation located in Phoenix, Arizona,  
2 registered a trade with AQMD on March 12th, 2001, in which they  
3 purchased 25,000 pounds of Cycle 2, 2001 NOx from Cantor  
4 Fitzgerald, a broker, at \$16.50 per pound, for a total cost of  
5 \$412,500.

6 On March 29th, 2001, a trade was registered for  
7 these same credits, with Pinnacle West selling them to NRG's El  
8 Segundo Power facility at \$43.50 per pound, for a total of  
9 \$1,087,500, which is a \$675,000 increase.

10 It should be noted that El Segundo Power has  
11 regularly purchased RTCs directly through the Cantor Fitzgerald

12 broker service. In fact, they've made more than 75 purchases  
13 directly with that broker.

14 The RTC Transaction Forms that the companies need  
15 to register these trades with the District, these Registration  
16 Forms for the buy and sell were signed by Steve Norris, Pinnacle  
17 West's representative, on the same day, February 22nd, 2001.

18 Further examination of the actual underlying  
19 contracts show them to have been executed within a one-week  
20 period, with the buy from Cantor on December 28th, 2000, and the  
21 sell to NRG on January 4th, 2001 for March 15 delivery.

22 The actual sales contract reveals that a Texas  
23 broker, United Power, was paid a commission by NRG Power  
24 Marketing for the sale by Pinnacle West, which is referred to in  
25 the actual sales contract as the Arizona Public Service Company,  
26 which is apparently owned by Pinnacle West.

27 Now, the RECLAIM program and trade deals,  
28 however, are complex. When we reviewed the actual buying

1 contract, it was actually a stream of "credits", quote-unquote,  
2 that was purchased by Pinnacle West from Cantor Fitzgerald for  
3 the five years from 2001 through 2005 at a fixed price of \$16.50  
4 per pound, but the later year credits were not registered with  
5 AQMD until about two months later.

6 It could be argued that the 2001 through 2003  
7 credits were worth more at the sales time, but regardless, it's  
8 important to note that RTC prices have varied greatly. The same  
9 power company that bought these credits, NRG El Segundo,  
10 registered trades with the AQMD same vintage RTCs directly from  
11 Cantor Fitzgerald for 10,000 pounds at \$25 per pound in November  
12 of 2000, and for 22,956 pounds at only \$5.75 per pound, and  
13 30,000 pounds at 27.75 per pound in January of 2001. Later that  
14 month, then, they registered trades at \$48 and \$40 through a

15 direct purchase with another RECLAIM facility, and then a  
16 separate transaction with a different broker.

17 So thus, it's clear that the prices paid by the  
18 same company have varied greatly. Power generation companies  
19 purchased two-thirds of all the year 2000 NOx RTCs that were  
20 traded. Also, third party marketers have profited from the  
21 turnover of RTCs.

22 Therefore, it's my opinion that third party  
23 marketers and energy corporations have greatly influenced the  
24 price of NOx RTC credits. Full RTC transaction logs are being  
25 provided to the committee's economic consultant in Irvine for  
26 analysis.

27 In closing, one of the committee's staff had also  
28 asked if we have any other examples of unusual issues regarding

1 power generation facilities. Two basically come to mind.

2 First, one power company, AES, has created a  
3 holding company type entity called AES Huntington Development,  
4 Inc., that is now not only buying from other RECLAIM facilities  
5 and then selling to both AES Huntington Beach and AES Redondo  
6 Beach, currently at a loss, but also buying and currently  
7 holding credits from these two AES facilities. This means that  
8 credits are potentially able to flow between AES entities with  
9 price rather than at the zero price as other commonly held or  
10 related facilities.

11 Second, after the recent installation of SCR  
12 control equipment at AES Alamos and Redondo Beach, it has been  
13 reported to our engineering manager, who reports to me, that a  
14 critical fan serving each SCR unit is not sized properly,  
15 resulting in the derating of both units until new blowers can be  
16 procured and installed. AES staff have informed the AQMD that  
17 the ISO may require them to operate while bypassing the SCR.

18 AQMD is concerned that as AES characterizes  
19 themselves, quote, "a leading global power company," unquote,  
20 with businesses in 26 countries, that they would not ensure  
21 proper engineering evaluation of this project to include  
22 adequate fan size. This error creates the threat that  
23 long-planned controls may be bypassed, thus harming the  
24 environment while incurring greater mitigation fees, and thus  
25 greater power costs. At minimum, operation of the units at  
26 derated levels results in less power supply in the State of  
27 California.

28 I want to thank you for the opportunity to  
  
1 present this information.

2 Barbara Baird, AQMD District Counsel, who's  
3 familiar with our FERC testimony personally, and I are both  
4 available here to answer any questions that you may have.

5 CHAIRMAN DUNN: Let's go ahead. Thank you very  
6 much for the prepared text because it got right to the core, as  
7 you well know, of why we asked you to come today.

8 But I want to spend a little time explaining it  
9 and its relevance to the behavior in the wholesale electricity  
10 market for the lay person, so that we have a good understanding  
11 of exactly what's going on, at least from the evidence that  
12 you've reviewed, as well as its relevance as well.

13 So let me just state that question. When it  
14 comes to the price tag of NOx credit, how does that impact, or  
15 what is its relevance to the wholesale price of electricity now?

16 MS. COY: Now, after the end of April, the  
17 Federal Regulatory Board, FERC, has set up a proxy price  
18 mechanism whereby one of the brokers, Cantor Fitzgerald's  
19 average price for RTC NOx credits would be used to determine the  
20 emissions credit price for power throughout the state.



21                   However, throughout this year, there has  
22 basically been a pass-through allowed for any emission credit  
23 prices, any generation prices, to be reflected in wholesale  
24 market prices as bids go into the ISO.

25                   CHAIRMAN DUNN: And I understand, and you may  
26 want to bring counsel up at this point, but I think, Ms. Coy,  
27 you probably have sufficient familiarity, so at least let's try  
28 it with you first.

1                   It's that April 26th order by FERC that has  
2 caused great concern to the AQMD; correct?

3                   MS. COY: That's correct.

4                   CHAIRMAN DUNN: Can you share with us some of the  
5 concerns that AQMD has with respect to that April 26th FERC  
6 order?

7                   MS. COY: The FERC order basically removes any  
8 incentive. Actually, it disincentivizes any -- any attempt to  
9 keep prices low --

10                  CHAIRMAN DUNN: When you refer to prices --

11                  MS. COY: -- in the NOx market --

12                  CHAIRMAN DUNN: There we go.

13                  MS. COY: -- so NOx credit price is low, as well  
14 as it disincentivizes the use of the cleanest power generation  
15 units.

16                  And what the District would refer to basically as  
17 environmental dispatch, a concept where we believe that for  
18 environmental good, we should be dispatching electricity using  
19 the cleanest units first. That's what I'm referring to as  
20 environmental dispatch.

21                  It would then disincentivize environmental  
22 dispatch, which is something that we have been negotiating with  
23 our own power generators now for months.

24 CHAIRMAN DUNN: Let's go specifically to the  
25 issue of the FERC order, including within the proxy price the  
26 NOx credit emissions, which is what the filings by the AQMD is  
27 concerned about.

28 MS. COY: Yes, and Barbara, who prepared the 1

1 filings, would be most familiar with the exact details.

2 CHAIRMAN DUNN: Barbara, please join us. We'll  
3 have you state your name in just one second, Barbara.

4 At the Chair's request, we let go of Leg.  
5 Counsel, so she's not here to swear you in.

6 Would the Committee have any objection to  
7 allowing counsel to testify without placing her under oath?

8 Please, have a seat. I think we've got an  
9 opinion.

10 We'll trust your ethical requirement to the Bar  
11 to guide your testimony today. Please state your name.

12 MS. BAIRD: My name is Barbara Baird, District  
13 Counsel.

14 And I was involved in preparing the filings that  
15 we made with the FERC. So, to the extent it has to do with the  
16 concerns that the District raised with the FERC and so forth,  
17 then I would be the best prepared to answer those.

18 CHAIRMAN DUNN: And if I may, Ms. Baird, I'm  
19 going to give you a platform for a minute.

20 Most of the committee members are familiar with  
21 the filings that AQMD made to FERC with reference to that  
22 April 26th FERC order.

23 Can you just briefly walk us through the concerns  
24 that were expressed in those filings?

25 MS. BAIRD: Certainly.

26 The first concern was that the FERC order

27 appeared to contemplate that RECLAIM trading credit prices as  
28 reported on the Cantor Fitzgerald web site would be used as part  
1

1 of the proxy price, where the power producers are allowed to  
2 recover that price without needing to justify it in terms of  
3 potential refunds for being in excess of price.

4 In other words, the power companies would all be  
5 able to recover that cost, whether or not they had actually  
6 incurred that cost.

7 Our significant concern there was two-fold. The  
8 first concern is that the RECLAIM trading credit price is really  
9 no longer relevant at all to what power producers actually have  
10 to pay because of some changes that we had made in the program

11 CHAIRMAN DUNN: Ms. Baird, my apologies for  
12 interrupting.

13 Explain that in some detail, why, for this time  
14 period, winter and spring and up till now -- my words now --  
15 it's really not relevant to this calculation?

16 MS. BAIRD: Sure.

17 The power producers had expressed concerns to us  
18 that they were having difficulty in complying with their RECLAIM  
19 caps that Carol described, and they also -- there were very high  
20 prices which caused our Board to be concerned that facilities  
21 other than power producers that are required to purchase these  
22 credits in order to comply would have difficulty in affording  
23 those credits. And basically, they told us that they might have  
24 to curtail operations or cease operations if something wasn't  
25 done about this problem.

26 Subsequent to the Governor issuing the Executive  
27 Order declaring -- or issuing the Proclamation of Emergency on  
28 January 17th, our District Executive Officer determined to issue  
1

1 an executive order, which is authorized by one of our rules,  
2 which is basically contingent on the Governor declaring an  
3 emergency. Our Executive Officer then authorized to suspend for  
4 a limited period of time, ten days at a time, the operation of  
5 District rules.

6 So, what he did is, he suspended the RECLAIM  
7 Program insofar as it applied to power producers who had run out  
8 of RECLAIM allocations and said they no longer had to purchase  
9 credits. This was effective February 6th. They no longer had  
10 to purchase credits in order to operate at whatever level was  
11 necessary for them to operate, but they did need to pay to the  
12 District a mitigation fee of \$7.50 per pound of NOx pollution  
13 emitted.

14 And we then committed that we would use that  
15 money to obtain emission reductions from sources that are not  
16 otherwise regulated, and therefore, providing a net emission  
17 reduction equivalency as to what would have occurred if the  
18 power plants hadn't exceeded their caps.

19 So, that Executive Order basically made it so  
20 that power plants did not have to comply by buying RECLAIM  
21 credits as of February 6th.

22 SENATOR MORROW: What was the mitigation fee  
23 again?

24 MS. BAIRD: Yes, it's \$7.50 per pound of NOx  
25 emissions, whereas the price that Carol testified to you earlier  
26 was in the neighborhood of \$43, and prices had gone up to as  
27 high as \$62.

28 After we issued our Executive Order, at the same

1

1 time we were also developing proposed rule amendments at the  
2 Board's direction which would attempt to separate the power  
3 producers from the RECLAIM market. And those amendments were

4 adopted on May 11th of this year, basically formalizing in  
5 permanent regulation the fact that power producers are now out  
6 of the RECLAIM trading credit market for at least the next three  
7 years.

8 So, instead of paying for RECLAIM credits, they  
9 will be paying the mitigation fee to us, and we will be using  
10 that money to obtain equivalent emission reductions elsewhere.

11 So, that was our first concern, was that RECLAIM  
12 prices, per se, were not relevant to power producers.

13 But our second concern was that we were worried  
14 that the FERC, on learning that, would then conclude that the  
15 thing to do would be to charge in the proxy price the 7.50 per  
16 pound mitigation fee. And we were continuing to be concerned  
17 that even that would have the potential for incentivizing power  
18 producers to not reduce their emissions appropriately.

19 That -- we had basically three reasons for being  
20 concerned about that. The first reason was that because the  
21 proxy price is based on the highest emitting, least efficient  
22 unit that actually is dispatched into the market, it would  
23 incentivize power producers to actually offer into the market  
24 those dirtier, more expensive, and least efficient units.

25 The reason we were concerned it would provide  
26 that incentive was, all their other units and every other power  
27 producer in the market would recover those costs whether or not  
28 they actually incurred them.

1

1 CHAIRMAN DUNN: Senator Bowen.

2 SENATOR BOWEN: Let me see if I can rephrase what  
3 you're saying so I make sure I understand.

4 You're saying that if any one generator who owns  
5 a very inefficient plant runs it on a particular day, that  
6 everybody else gets the benefit of that higher price from the

7 inefficient, the least efficient plant?

8 MS. BAIRD: That is our understanding of how the  
9 order operates, yes.

10 SENATOR BOWEN: Mine, too.

11 So what happens then is that everyone is better  
12 off if at least one inefficient plant is running than if only  
13 clean, more efficient plants are operating. Everyone else makes  
14 more money.

15 MS. BAIRD: That was our concern, yes.

16 CHAIRMAN DUNN: Let me make the final connection  
17 there, if I may.

18 The way that, as Senator Bowen referred to it,  
19 that everyone makes more money is that they're allowed to  
20 include those costs in the variable costs calculation?

21 MS. BAIRD: Correct. And it's our understanding  
22 that the way the proxy price works is, prices that are at that  
23 level are not subject to future justification for purposes of  
24 whether or not they are just and reasonable under the Federal  
25 Power Act.

26 CHAIRMAN DUNN: So, one could suggest that the  
27 incentive for the power generators would be to ensure that the  
28 variable costs, as recognized by FERC, are high, very inclusive?

1

1 MS. BAIRD: That would be our concern, yes.

2 CHAIRMAN DUNN: And in fact, that's going to lead  
3 me to the next thing as expressed in the filings made by the  
4 AQMD.

5 One of the other concerns, given the suspension  
6 of the RECLAIM program and then the April 26th FERC order, is  
7 that there was potentially an incentive to artificially drive up  
8 the price of the NOx credits in the NOx market?

9 MS. BAIRD: If the intent of the order was to

10 continue to use RECLAIM credits, yes, we were concerned about  
11 that.

12 CHAIRMAN DUNN: And explain that in some detail,  
13 if you would, Ms. Baird. What was the concern in that regard?

14 MS. BAIRD: Well, I think it's basically what you  
15 just articulated, that the higher the proxy price, the more  
16 everyone benefits. And that if the proxy price includes the  
17 cost of RECLAIM credits, then there would obviously be an  
18 incentive to at least make sure that those credits -- or avoid  
19 trying to reduce the cost of those credits, but it actually  
20 would be beneficial to power companies to have those credit  
21 prices go higher.

22 CHAIRMAN DUNN: Let's talk about the historical  
23 perspective of the NOx credit market.

24 If we went back, say, two years, how would you  
25 describe that market?

26 MS. BAIRD: Can you be more specific? And you  
27 may be getting into Ms. Coy's area of expertise now at this  
28 point.

1

1 CHAIRMAN DUNN: And we're happy to go back to  
2 you, Ms. Coy.

3 Let me tell you exactly where I'm coming from.

4 In the filings at FERC, the AQMD described the  
5 historical perspective of the NOx credit market as being very  
6 stable, and that it is only in recent memory that the market has  
7 seen volatility.

8 MS. COY: Yes, basically up through 1998, NOx  
9 RTCs were selling at an average about a dollar a pound, which  
10 would be about \$2,000 a ton.

11 In 1999, that had doubled to about two dollars,  
12 and I have included in some material that I had e-mailed up to

13 the committee, Page 241 shows the average prices.

14 CHAIRMAN DUNN: Hold on, Ms. Coy. Let's bring  
15 that up real quickly so everybody can see it.

16 MS. COY: Page 241.

17 Basically in '99, prices averaged about two  
18 dollars per pound, or \$4,000 a ton. But in 2000 then, starting  
19 around September -- so we're talking about in the fall, and this  
20 was, of course, after electrical prices had increased earlier in  
21 the summer, despite what has been alluded by many -- the prices  
22 began to just skyrocket. And we actually ended up with an  
23 average price now -- this means that you had quite a few higher  
24 than this -- of \$45,609 per ton for 2000.

25 And so, as Barbara had testified, we had a high  
26 of actually \$62 a pound for one trade.

27 And so, this is basically the general trend that  
28 was seen.

1

1 Now, it was also, if we look at Page 232, as  
2 Senator Bowen has held up, this chart basically shows you the  
3 average prices through the summer of '99 through the fall of  
4 2000. And basically our prices are pretty similar, if you just  
5 draw this line on out. But you can see that the RECLAIM prices  
6 began to go up at the end of summer, and basically took this  
7 incredible leap then in the fall, in September and October,  
8 where they've basically just fluctuated a little when you look  
9 at the average price.

10 One last thing, though. When we talk about NOx  
11 credit price increases what I'd like to point out would be on  
12 Page 233, there's a little chart up in the upper right-hand  
13 corner. It's that part of this that I wanted to draw the  
14 committee's attention to.

15 Basically what this chart shows -- oh, thank you



16 very much.

17 CHAIRMAN DUNN: She's pretty talented; isn't she.

18 MS. COY: I'm very impressed.

19 The reported emissions from companies are  
20 basically the line that starts nearest to the left of the page.  
21 And you can see that this is basically the actual reported line  
22 for companies in the RECLAIM program. That's their actual  
23 emissions.

24 The line that it intersects then is, starting in  
25 1994, that's actually the total RTC allocation line for the  
26 program. So, this is that declining annual cap that I was  
27 referring to in my testimony.

28 As you can see, we marched closer and closer with  
1

1 actual facility emissions, drawing very near that line, and in  
2 1999, nearly intersecting it.

3 So, that point there was considered what we  
4 called the cross-over point. It was long predicted to occur,  
5 where without adding major control equipment, companies -- their  
6 supply and demand curve was going to cross.

7 So, certainly NOx credit prices went up because  
8 the supply and demand issue had been reached, but at the same  
9 time, it was hugely exacerbated by the confluence of this event  
10 with then the power generation shortfall, where all of the  
11 uncontrolled plants were then run at well beyond any historical  
12 levels.

13 CHAIRMAN DUNN: Senator Bowen.

14 SENATOR BOWEN: I do I have a question.

15 This is exactly what I was going to ask you  
16 about, because there is a declining supply of credits, so we  
17 would predict that if there were no other factors, that the  
18 price might go up.

19                   Did you do any kind of projections about pricing?  
20   What that might do to prices?

21                   MS. COY:  Yes.  In the very initial economic  
22   analyses for this program back in 1993, it was predicted that  
23   the cross-over point would have occurred at least a year  
24   earlier.  And it was thought that the price of RTCs, the  
25   credits, would actually closely parallel what we call the  
26   marginal cost of control, the actual cost to control your  
27   emi ssions.

28                   SENATOR BOWEN:  The theory would be, these people<sup>1</sup>

1   would avoid having to purchase the credits at the point that it  
2   cost that amount or less to install?

3                   MS. COY:  Yes, which is now exactly what's  
4   happened.

5                   SENATOR BOWEN:  But in your view, the amount of  
6   the increase, if we could go back one chart, Page 232, the  
7   credits crossed in 1999?

8                   MS. COY:  Yes, for all intents and purposes.

9                   SENATOR BOWEN:  But the price didn't change in  
10   any significant measure until power prices started to go up in  
11   the spring of 2000.

12                   MS. COY:  Substantially, yes.  No substantial  
13   price increase, although the prices had indeed doubled in 1999,  
14   to the two dollars per pound.

15                   SENATOR BOWEN:  And natural gas prices had also  
16   about doubled in that time period, but this big spike at the end  
17   is certainly not something your economic models would have  
18   predicted?

19                   MS. COY:  No.  To my knowledge, there is no one  
20   familiar with the RECLAIM program who ever predicted this type  
21   of price spike and increase to this incredible degree.

22                   SENATOR BOWEN: And let me ask you about the  
23 suspension of the credit requirement and the rule making that  
24 separated the power producers from the RECLAIM program.

25                   That rule making that separated the power  
26 producers was caused, was initiated as a result of this price  
27 run up; right?

28                   I was hearing, at least in my district,

2

1 complaints from businesses saying that they couldn't purchase  
2 RECLAIM credits at any kind of rational level.

3                   CHAIRMAN DUNN: May I interrupt for one second,  
4 Senator Bowen?

5                   In fact, Ms. Baird, wasn't that one of the  
6 concerns expressed in AQMD's FERC filings, the ancillary effect  
7 on other businesses, and as the price went up in the NOx credit  
8 market, they would not be available to other businesses?

9                   MS. BAIRD: Yes, we expressed that concern as  
10 well.

11                   I think Carol's prepared to explain about the  
12 rule making as well.

13                   SENATOR BOWEN: Can you describe the genesis of  
14 that rule making, and the concern about whether the RECLAIM  
15 Program could continue to work with power producers in the  
16 program?

17                   MS. COY: Yes. We had extensive discussions with  
18 actually, well, the majority of RECLAIM facilities that were  
19 nonpower plants during this time.

20                   And these business owners expressed extreme  
21 concern that many of them had been watching the price of NOx,  
22 but of course, had never anticipated this type of incredible  
23 spike to occur so quickly. And they had many cost-effective  
24 controls at their -- at their hands, basically, controls at

25 about \$4,000-8,000 per ton of NOx reduced. So, when I'm saying  
26 cost-effective, that is in air pollution terms very moderate  
27 cost. And yet, suddenly found themselves facing \$30 per pound  
28 costs.

2

1 So, \$60,000 a ton for credits, they cannot afford  
2 those credits, they have represented to us, because they could  
3 not pass that cost through to consumers for their products and  
4 remain competitive with companies that were outside of the  
5 RECLAIM program, thus out of state or out of the country.

6 SENATOR BOWEN: Or in a different air basin,  
7 presumably.

8 MS. COY: Exactly.

9 So, with that concern, our District governing  
10 board was very concerned that we needed to moderate and lower  
11 the price of NOx credits. And they asked the staff to focus on  
12 the elements that, in program adjustments, that would provide  
13 the fastest, most effective cost reduction and stabilization.

14 And since the electrical generators basically  
15 were causing the greatest short-term impact, most of the May  
16 amendments were actually focused on that particular part of the  
17 market, to basically give those generators a time-out, which  
18 then would allow them --

19 SENATOR BOWEN: Gee, if you could accomplish  
20 that, we'd like to know how.

21 MS. COY: And thus allow the RECLAIM companies,  
22 who were now attempting to comply by adding on control, the lag  
23 time that they needed in order to design, permit, procure, and  
24 install control equipment.

25 SENATOR BOWEN: I want to thank you for taking  
26 that action to separate the market, because I was hearing from  
27 many of the businesses in my district, which is entirely within

28 the L. A. Basin, air basin, these concerns.

2

1 I'm also curious to know how you set the \$7.50  
2 mitigation fee, because it seems to be far below the results  
3 that were being produced on the market.

4 MS. COY: Certainly. There are actually several  
5 reasons.

6 At the time of program development in 1993, there  
7 was a concern that businesses to comply with what are basically  
8 end points -- if you remember back to the chart, the allocation  
9 declines up to 2003, and then remains steady for the remainder  
10 of the program, which is into infinity.

11 And so, many businesses were concerned during  
12 program design that to comply with that end point amount in  
13 2003, that they might be required to install new, very expensive  
14 control technologies. So, there was what was called a back-stop  
15 level set in the initial program rules at 7.50 per pound, or  
16 \$15,000 per ton, which was in 1993 just about the high end of  
17 control equipment costs that were being required by the command  
18 and control rules that the Board was adopting in public hearings  
19 at that time.

20 And so, the program was established with a  
21 \$15,000 per ton back-stop level, which, if reached, would  
22 trigger a governing board assessment of whether the program was  
23 working, and effectively, and in a cost-effective manner.

24 Also, in just recent months, there have been  
25 other air pollution reduction programs, such as the Carl Moyer  
26 Program, which in our District was -- actually had what's called  
27 oversubscribed, meaning there were more applications to create  
28 emissions reductions at about a \$13,000 level all ready. There  
2

1 were emission reductions available at that level which had not

2 yet been used in that program.

3 And so, we know the District's staff analysis was  
4 that there were emission reductions available in that general  
5 vicinity of cost, so the staff had quite a bit of assurance that  
6 if we had a mitigation fee at \$15,000 per ton, that the District  
7 would be able to contract for offsetting emission reductions  
8 that would basically make the environment whole for what would  
9 have been the resulting removal of any sort of limit on power  
10 plant operation as far as emissions went.

11 SENATOR BOWEN: Thank you.

12 CHAIRMAN DUNN: Ms. Coy, you had mentioned during  
13 some of your earlier comments about, as the credit market, N0x  
14 credit market, became more volatile, and we watched as the  
15 prices started to make a rather steep climb, beginning  
16 approximately May of 2000 in that average price, that's when the  
17 steep climb started. Page 232, if I'm looking at the chart  
18 correctly, and correct me if I'm wrong.

19 MS. COY: September 2000.

20 CHAIRMAN DUNN: A slow climb from spring, but  
21 then they really started to spike in the fall of 2000.

22 And you mentioned that there was the arrival of,  
23 I think you referred to them as the third-party marketers in  
24 that N0x credit market.

25 MS. COY: Yes. As prices began to go up, we saw  
26 more third-party marketers that you could consider private  
27 investor-type organizations begin to buy credits and deal in  
28 credits.

2

1 CHAIRMAN DUNN: Was this something relatively new  
2 for the N0x credit market?

3 MS. COY: Yes, it was.

4 CHAIRMAN DUNN: Prior to that time, it was

5 basically direct sales between the owners of the NOx credits?

6 MS. COY: Yes, with broker assistance through a  
7 number of brokerages that basically traded these credits on a  
8 commission basis, much like a real estate broker.

9 CHAIRMAN DUNN: And you referred to the primary  
10 broker who publishes these prices, what's that name again?

11 MS. COY: Cantor Fitzgerald was the one that was  
12 involved with the proxy price mechanism.

13 CHAIRMAN DUNN: From your observations at the  
14 AQMD, when did you see the arrival in that market of the first  
15 pure traders of NOx credits?

16 MS. COY: Although I'd have to do some research  
17 to go back to it, I believe it was pretty much in the fall of  
18 2000, to the best of my recollection. And before that, with  
19 prices so low, there was practically no interest.

20 CHAIRMAN DUNN: No traders were interested in it.  
21 Can you identify for us the traders that are in  
22 that market, the NOx credit market? Who are they, to the best  
23 of your recollection?

24 MS. COY: I could provide the committee with a  
25 list of non-RECLAIM facilities that have dealt in buying and  
26 selling RTCs. And the list would be rather lengthy. It's  
27 probably over two dozen companies. They would include  
28 multi-fuels marketing, multi-fuels emissions marketing, Pinnacle

2

1 West Marketing and Trading.

2 I would need to refer to a complete list, and I  
3 can certainly get that for your committee staff.

4 CHAIRMAN DUNN: If you would, please, that would  
5 be wonderful, Ms. Coy, if you could.

6 To the best of your knowledge, does it include  
7 any of what I will refer to as the trading arms of the major

8 power generators?

9 MS. COY: The company that I had described as an  
10 example of a holding company, AES Huntington Development, would  
11 have come on the scene since the fall of 2000. And they,  
12 however, AES trades their own credits amongst the facilities at  
13 zero price.

14 So, I don't understand what a trading arm would  
15 be.

16 However, there are other energy corporations,  
17 such as Williams Energy, who began to buy and sell credits as  
18 well who would, again, be a third-party entity, since they do  
19 not actually permit and operate a facility.

20 CHAIRMAN DUNN: Those are the ones I'm  
21 questioning. Let me name four others, and tell me if, to your  
22 knowledge, they're engaged in any way in trading of NOx  
23 credits: Duke, Dynegy, Reliant, or Mirant/Southern?

24 MS. COY: To the best of my knowledge, I  
25 recognize Reliant clearly, but I believe that their trading had  
26 been associated with an actual facility that was owned by them.

27 The others, the actual corporations themselves,  
28 to the best of my recollection, have not done any direct RTC  
2

1 trading.

2 CHAIRMAN DUNN: I want to bring in kind of  
3 summary form what we've talked about in a little bit of a  
4 scattered fashion.

5 Before I do that, I think, Larry, you had a  
6 question you wanted to pose.

7 MR. DRIVON: Could we have Page 233, please.

8 Ms. Coy, you indicated that there was an  
9 anticipation of a crossing of the lines having to do so with  
10 supply and demand with respect to these credits; correct?



11 MS. COY: That's correct.

12 MR. DRIVON: And this was an anticipation that  
13 your agency had had for some period of time prior to its actual  
14 occurrence; is that right?

15 MS. COY: Yes. It was known at the beginning of  
16 the program in 1993 that, at program design time, that there  
17 would be a point where we would be reaching a cross-over.

18 MR. DRIVON: Was it expected by the agency then  
19 that when that cross-over time occurred, that compliance would  
20 speed up, and the prices of credits would increase?

21 MS. COY: The program design actually  
22 contemplated that as the cross-over point was approaching, that  
23 you would begin to see more attention to the installation of  
24 control equipment because prices would be going up on credits,  
25 and companies would be able to foresee that the cost of control  
26 was clearly less than the cost of credits.

27 MR. DRIVON: Now, the generators, electric  
28 generators, comprise what percentage of the total need for NOx<sub>2</sub>

1 credits in your district?

2 MS. COY: I would have to actually go back to our  
3 reference documents to provide you with the -- what percentage  
4 of emissions they were allocated, what percentage of emissions  
5 they actually used.

6 MR. DRIVON: It was quite a considerable  
7 percentage of the total; wasn't it?

8 MS. COY: Yes, it's a very high percentage, as is  
9 reflected in my testimony, that they bought two-thirds of all  
10 the credits sold for the year 2000.

11 MR. DRIVON: The use of these credits would tend  
12 to increase during times when the less efficient generating  
13 units needed to be on line, in other words, higher need times;

14 correct?

15 MS. COY: Yes, that's certainly so. The  
16 uncontrolled units emit much more NOx than the controlled units.

17 MR. DRIVON: So, the demand would be higher for  
18 these credits during times of peak electricity generation  
19 demand?

20 MS. COY: Yes, however, there is -- the RECLAIM  
21 program is established so that there are actually quarterly  
22 reconciliation time. So, if you are, for example, a Cycle One  
23 company, which is easy to think of, it's calendar year, you're  
24 reporting your emissions from these large units, although you're  
25 reporting actual emissions on a daily basis. You have to give a  
26 quarterly certification of compliance.

27 And at that point, you basically have 30 days at  
28 the end of each quarter with which to acquire adequate RTCs to  
2

1 reconcile for your quarter's emissions.

2 So, I, for example, could emit over my allocation  
3 in February and March, but I'd have until March 30th then to  
4 have adequate RTCs in my account to reconcile those emissions.

5 Then there's one difference in the fourth  
6 quarter. Since that's the end of your annual year, you have a  
7 60-day reconciliation period.

8 So, although I may be running a boiler a lot on  
9 March 1st, I don't have -- I still have basically a two-month  
10 period to acquire adequate emissions credits to account for  
11 those emissions.

12 MR. DRIVON: Now, when the mitigation fee scheme  
13 was put into place in the spring of 2001, is it?

14 MS. COY: Yes, the fee mitigation.

15 MR. DRIVON: That had the effect of lowering the  
16 demand for the use of NOx credits; didn't it?

17 MS. COY: By power companies.

18 MR. DRIVON: But power companies accounted for a  
19 very large percentage of the actual need for those credits prior  
20 to the time mitigation came?

21 MS. COY: Yes.

22 MR. DRIVON: Would it follow, then, that if the  
23 power generating companies were exempted from the need for the  
24 use of those NOx credits by the mitigation design, that the  
25 effective supply available to the balance of the people in that  
26 area that use them, the other companies, would increase?

27 MS. COY: Yes, that's correct.

28 MR. DRIVON: Would that not also probably be 2

1 expected to have the effect of lowering the cost of NOx credits  
2 on the market?

3 MS. COY: Yes, it is expected to do that.

4 MR. DRIVON: And what has happened?

5 MS. COY: Prices have dropped in general. And  
6 then, as we've neared reconciliation periods, have begun to  
7 creep up again.

8 There is also a \$7.50 Air Quality Improvement  
9 Program, AQIP Program, that was also adopted by the governing  
10 board at the same time the power plant time-out was adopted,  
11 which allows certain smaller companies who were what we call  
12 structural buyers, meaning, when the program was designed, there  
13 was no technology in sight that would allow them to meet their  
14 end point emissions levels, so they were thought to always be  
15 buyers in the program, and have been caught by these  
16 skyrocketing prices.

17 So, there was an AQIP fund established for these  
18 particular companies so that they could come to the District and  
19 pay 7.50 into the AQIP, which again, the District would use in

20 the same way as the mitigation fee to contract for offsetting  
21 emissions for them.

22 So, by also taking their demand out, and allowing  
23 them to be able to pay 7.50, it was thought that these actions  
24 would help give facilities other places to go for moderately  
25 priced credits, so that it would help stabilize the overall --  
26 stabilize and lower the NOx credit price.

27 MR. DRIVON: The effect of the third-party  
28 traders in this market you said has been to generally increase<sup>3</sup>

1 the price of these units; is that right?

2 MS. COY: Yes.

3 MR. DRIVON: And the prices, those increases,  
4 have been substantial; is that correct?

5 MS. COY: There have been substantial profits  
6 made on selling RTCs for more than they were purchased for,  
7 yes.

8 MR. DRIVON: Does the presence of the third  
9 parties in this market have the effect of drying up some of the  
10 available supply by holding it in the portfolios of these  
11 third-party traders?

12 MS. COY: It could have that effect, yes.

13 MR. DRIVON: And the general effect has been that  
14 the lowering of the NOx credit prices by taking the generators  
15 out of the need, taking away the need of the generators for  
16 using them, that the lowering of the prices has not been what  
17 you would have expected because, at least one reason, because of  
18 the presence of third-party traders; is that fair?

19 MS. COY: That would be one reason, yes.

20 MR. DRIVON: Thank you.

21 CHAIRMAN DUNN: Senator Bowen.

22 SENATOR BOWEN: I guess I'm missing something

23 fairly fundamental here.

24 Are you talking about the time period before  
25 May 11th or after, when you talk about what's happened with  
26 pricing?

27 MS. COY: I was talking about prices basically  
28 throughout the beginning months of 2001. There have been

3

1 general drops after the governing board announced potential rule  
2 amendments and the time out, and then, when the actual rule  
3 amendments went in.

4 But in general, credit prices have continued to  
5 creep up from some lower levels directly after those actions.  
6 And you must remember that we have a big decline again in RTCs  
7 that are available this year, so supply and demand for these  
8 RTCs is very tight.

9 SENATOR BOWEN: I guess my question is, why power  
10 producers would be trading credits at all if they're no longer  
11 in the RECLAIM program?

12 MS. COY: Well, we've asked ourselves that  
13 question, and we've actually tried to investigate a little.

14 And one of the things that we've discovered is  
15 that many of the transactions that have been registered  
16 recently, the trading partners have provided us contracts that  
17 show that they had made these agreements quite awhile ago, in  
18 the way of almost a forward contract type agreement. So, over  
19 the last several months, we've received a lot of trade  
20 registrations that the parties claim had been agreed to at a  
21 much earlier date.

22 SENATOR BOWEN: What are the rules about filing a  
23 trade registration?

24 MS. COY: Those registration, there was  
25 previously no specific rule, except that in order to use credits

26 to reconcile emissions, those credits needed to have been traded  
27 by the end of each reconciliation period.

28 SENATOR BOWEN: In other words, you could make an  
3

1 arrangement to purchase a lot of credits four or five months  
2 ahead, you just had to have filed the document before the actual  
3 date of use?

4 MS. COY: Yes, and because of that, the District  
5 governing board has adopted a rule change that requires now that  
6 these transaction disclosures be filed just a short time after  
7 the agreement is made.

8 SENATOR BOWEN: I'm imagining what would happen  
9 in the stock market if you allowed people to accumulate stock  
10 for months at a time without having to disclose any of it,  
11 either the acquisition or the price, because by delaying the  
12 filing, neither is disclosed, right? Neither the quantity nor  
13 the price.

14 MS. COY: That's exactly correct. And thus, the  
15 trading public did not have the full picture and fresh  
16 information about what the actual prices were for credits.

17 CHAIRMAN DUNN: Ms. Coy, I had mentioned before,  
18 I want to bring it to its focal point here.

19 Let me ask the question in the following way.  
20 Given the fact that FERC appears to include emission credit  
21 price in establishing a proxy price, as a follow-up to Senator  
22 Bowen's question, isn't it true that other than the traders of  
23 these credits, the power producers are the only ones that truly  
24 benefit by a higher NOx credit price?

25 MS. COY: Assuming that the pass-through was  
26 allowed to be included in the equations that we've discussed  
27 today, yes.

28 CHAIRMAN DUNN: Nobody else that we can figure

1 out, at least reasonably, that would benefit from this?

2 MS. COY: The brokers who base their commissions  
3 on the actual price of the sales transactions would also  
4 benefit.

5 CHAIRMAN DUNN: And given the fact, as Senator  
6 Bowen and others have mentioned, that the power producers are  
7 now outside of the RECLAIM Program, that's one of the bases that  
8 prompted your filing at FERC, saying it makes no sense to  
9 include the price of this credit in establishing a proxy price,  
10 because unfortunately, one of the things that process does is  
11 incentivize the power producers to drive up the price?

12 MS. BAIRD: That was the basis for our filing.

13 I should point out that numerous parties have  
14 made filings in the FERC proceedings, and some of the power  
15 producers actually made filings that indicated that in their  
16 opinion, the FERC had not provided sufficient means of  
17 recovering emissions costs.

18 CHAIRMAN DUNN: So, they wanted even more.

19 MS. BAIRD: They were concerned about the  
20 possibility of having future year deductions from their future  
21 year allocations causing them to incur additional costs that  
22 they would not be able to recover.

23 CHAIRMAN DUNN: Donna, I want to go to 71.

24 Do you see the paragraph in the middle, starting  
25 "By using," highlight the rest of that page.

26 This, Ms. Baird, is actually directly from your  
27 -- not your personally -- but the South Coast Air Quality  
28 Management District's filing at FERC. I want to read this very

3

1 quickly:

2 "By using the current Cantor  
Page 30

3                               Fitzgerald posted price, "  
4       Which we've talked about, Ms. Coy,  
5                               "to establish prices for power,  
6                               even though it is not relevant,  
7                               the FERC has created incentives  
8                               for intervention and price  
9                               manipulation in the RTC market. "  
10                              The RTC is the RECLAIM credit market; correct?  
11                              MS. BAIRD:   That's correct.  
12                              CHAIRMAN DUNN:   Power companies may still  
13       purchase RTCs even though they may no longer use them if they're  
14       outside of the RECLAIM Program; correct?  
15                              MS. BAIRD:   That's correct.  
16                              CHAIRMAN DUNN:   "Also, companies  
17   related to power producers  
18   participate in the RTC market.  
19   Power companies, their  
20   affiliates and their agents  
21   will have every incentive to  
22   bid up price of RTCs so long as  
23   RTC prices are included in any  
24   FERC-established market price  
25   for power. "  
26                              Next paragraph:  
27   "SCAQMD recently observed at  
28   least one instance of a power

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1   plant paying two to three times  
2   the market price for RTCs that  
3   had been previously sold at the  
4   market price to an out-of-state  
5   purchaser and were then resold



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6 at the inflated price to the  
7 power producer. Both the sale  
8 and the inflated resale were  
9 recently registered on the same  
10 day with the SCAQMD. "

11 I believe this is one of the circumstances you  
12 discussed, Ms. Coy, in your prepared text; correct?

13 MS. COY: Yes, and I've provided the committee  
14 with copies of the trades, the trade registrations, that we  
15 based the statement on.

16 CHAIRMAN DUNN: And this filing, I believe the  
17 date was May 29th of 2001; correct, Ms. Baird?

18 MS. BAIRD: That's correct.

19 CHAIRMAN DUNN: We're a couple weeks later,  
20 Ms. Coy. Any reason to question what was set forth in the  
21 filing here that I just read?

22 MS. COY: Only the information that I had  
23 testified to, that on investigation by myself in obtaining the  
24 actual contract underlying the original purchase at 16.50, that  
25 it had been reported to the District as a single-year purchase;  
26 and yet, the actual underlying contract was truly a stream of  
27 credits.

28 So, the caveat is solely that stream of credit  
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1 purchases can be at a more average price for the years involved  
2 rather than a specific; however, that had not been reported to  
3 the District originally. That's why I've included all of the  
4 forms for your examination.

5 CHAIRMAN DUNN: Understood.

6 But that caveat that you just expressed does not  
7 call into question what basically was provided for in this  
8 filing?

9 MS. COY: That's correct.

10 CHAIRMAN DUNN: Is it your opinion, Ms. Coy, that  
11 at least arguably, this sort of buying and selling,  
12 repurchasing, in a very short period of time could be consistent  
13 with a strategy to drive up the NOx price?

14 MS. COY: It's consistent with that type of  
15 observation.

16 CHAIRMAN DUNN: Questions?

17 SENATOR MORROW: Thank you.

18 Ms. Coy, just a couple things I need to clarify  
19 here.

20 Going back to the time period when basically the  
21 Governor responded and did away with the NOx emission credit  
22 program, RECLAIM, establishing the mitigation fee, I think you  
23 said that was formalized on May 11th of this year?

24 MS. COY: That was actually a District governing  
25 board rule changes to the RECLAIM Program itself in removing  
26 those power producers over 50 megawatts from the RECLAIM  
27 universe as far as RECLAIM trading credit requirements.

28 SENATOR MORROW: That's when it went into effect?  
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1 MS. COY: It actually was retroactive to the  
2 January 12th date that the governing board had had their initial  
3 discussion on.

4 SENATOR MORROW: The Governor took the action in  
5 the form of an Executive Order; right?

6 MS. COY: I would need to refer the question to  
7 Barbara.

8 SENATOR MORROW: I'm trying to get a time period.

9 MS. COY: Just to separate what the Executive  
10 Order did versus the governing board.

11 SENATOR MORROW: Here's where I'm driving at.

12 I don't understand. Apparently there's trading  
13 in NOx emission credits going on right now. I think you said it  
14 was done in the course of a forward contracting type situation.

15 MS. COY: No, the actual trade that the committee  
16 had questions about that was referred to in the FERC filing had  
17 actually occurred between December 28th and January 4th this  
18 year, although it had not been filed with us until March  
19 timeframes.

20 And so, that is not a current trade that had just  
21 happened. That trade occurred previous to either the Governor's  
22 action or the District governing board's action.

23 SENATOR MORROW: But when that trade occurred,  
24 was there anything to give any indication at all to the trading  
25 parties that the RECLAIM Program would be done away with, as  
26 ultimately happened?

27 MS. COY: The governing board had had a regular  
28 agendized item on their board calendar in the fall of 19 -- I'm  
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1 sorry, of 2000, in which the District staff reported certain  
2 findings that the governing board needed to make to ratify the  
3 RECLAIM Program, and pointed out the great increase in NOx RTC  
4 prices.

5 At that board meeting, and I'm sorry, I don't  
6 recall which month it was; it was in the fall of 2000, governing  
7 board requested that the staff convene a working group, which  
8 basically I had chaired those meetings, and we identified all  
9 possible remedies to reduce and stabilize the NOx credit prices.

10 So, there was a public group that met actually on  
11 a weekly basis into December to put together a white paper of  
12 suggestions that was presented to the governing board in  
13 January.

14 So, the active participants in the RECLAIM market

15 knew that there was grave concern about the escalating NOx  
16 prices, and that the governing board was looking for suggestions  
17 for program adjustments to correct the situation.

18 SENATOR MORROW: As far as the trading, the  
19 ongoing trading that seems to be going on now in forward  
20 contracting, were any of these contracts signed after January of  
21 this year?

22 MS. COY: Forward contracts are being signed  
23 almost every day from my experience in seeing trades coming  
24 through now, with information having to be conveyed to the  
25 District in a very short timeframe.

26 But I can't to, just easy recollection, look to  
27 see whether any of those forward contracts involve any of the  
28 energy corporations without an analysis of the hundreds of

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1 trades that are passing through the District.

2 But we can and are providing that information to  
3 the committee consultant.

4 SENATOR MORROW: Thank you.

5 CHAIRMAN DUNN: Ms. Coy, just one follow-up  
6 question.

7 Given the fact that it appears that FERC is  
8 including in the setting of its proxy price the cost of NOx  
9 credits from the RECLAIM Program, doesn't that then benefit all  
10 of those outside the RECLAIM Program area of coverage by driving  
11 up that proxy price to their benefit as well, too?

12 MS. BAIRD: Perhaps I might be the more  
13 appropriate person.

14 It's difficult to answer this question for the  
15 following reason. What has occurred is that we had, in addition  
16 to filing our papers with FERC, we had previously been requested  
17 by their staff to provide an update regarding the executive

18 orders that we issued in February, taking the power producers  
19 out of the RECLAIM market.

20 We filed that letter with the FERC staff on the  
21 16th of May.

22 In response to that letter, which was widely  
23 publicized in that area, the Cal ISO, in implementing the FERC  
24 order, basically determined that the -- for setting proxy price,  
25 they would actually use a value of zero dollars, because they  
26 had been convinced that our arguments were correct, that those  
27 prices that appeared to be reflected in the FERC order did not  
28 actually apply. And that is presently subject of an emergency<sup>4</sup>

1 motion by the Reliant Company -- possibly among others; I'm not  
2 aware of others -- to attempt to have the FERC redirect the  
3 ISO's action in that regard.

4 So, it's difficult to say what effect it actually  
5 has had at this point because of the way the ISO has implemented  
6 that order.

7 CHAIRMAN DUNN: Do I understand you, Ms. Baird,  
8 to say that the Reliant filing, to the best of your knowledge,  
9 is asking that, in fact, that zero price not apply?

10 MS. BAIRD: They are asking that -- they haven't  
11 asked specifically what price they think should apply. They  
12 have asked FERC to order the ISO to implement the order in a  
13 different manner, and they have raised a number of arguments  
14 concerning that FERC order, but that is one of the arguments  
15 that they have raised.

16 CHAIRMAN DUNN: And if ISO is reversed, so to  
17 speak, by FERC, then in fact going back to my question that  
18 prompted this, then in fact those outside of the RECLAIM area,  
19 if a price is included for purposes of calculating a proxy  
20 price, then we have power generators that are going to be

21 beneficiaries when they haven't paid a dime?

22 MS. BAIRD: That would be correct.

23 CHAIRMAN DUNN: Senator Bowen, any further  
24 questions?

25 SENATOR BOWEN: One question.

26 Was it known when the District adopted or began  
27 the rule making in January that the order, whatever it was,  
28 would eventually be retro-active? In other words, that the

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1 credits wouldn't be needed during the period between the January  
2 decision to separate power generators from the RECLAIM market  
3 and the final rule making?

4 MS. COY: The January white paper discussion had  
5 a staff recommendation which clearly included the separation of  
6 the power generators and the fee mitigation proposal, as well as  
7 the subsequent year deduction to assure SIP approval. That was  
8 what the governing board then endorsed, and directed the staff  
9 to go back to write into rules.

10 So, at that point, the governing board had made  
11 clear that it was their intent that power companies' holdings be  
12 frozen as of January 11th, 2001, and that their allocation plus  
13 holdings as of that date would be used to assess what additional  
14 fee mitigation payments would need to be made.

15 And so, power companies at that point, many of  
16 them, reduced activity in the contracts that we've seen come  
17 forward. There's some purchases that were made post-  
18 January 11th, but many purchases that were filed all the way  
19 into March included contract proof that they had contracted  
20 before the January 11th deadline.

21 SENATOR BOWEN: Again, I'm trying to understand  
22 why there would be any reason for anyone to buy, any power  
23 producer, to buy credits for a time period after that January

24 date, unless the price were lower than the 7.50. And  
25 presumably, it was not.

26 MS. COY: Well, I've heard of several. The  
27 first, of course, and I'm going to just bifurcate off,  
28 companies, some of them, continued to buy credits from 2004

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1 forward, anticipating that the governing board would make needed  
2 findings in a public hearing in 2003 that would let them reenter  
3 the program

4 SENATOR BOWEN: That's fair enough. But I'm not  
5 talking --

6 MS. COY: -- current year --

7 SENATOR BOWEN: Sorry. I'm making the court  
8 reporter crazy.

9 CHAIRMAN DUNN: Or should we say, more crazy?

10 MS. COY: Secondly, there was a concern expressed  
11 by some power generators that there was -- that the RECLAIM rule  
12 amendments may not be federally approved. And so, some claimed  
13 that they were very concerned that they protect their Title Five  
14 permit compliance status by having adequate actual RTC, RECLAIM  
15 trading credit, coverage for emissions that were then going on.

16 So, that concern was expressed to District staff  
17 and to me personally by several representatives of different  
18 power generators who had continued to buy some credits.

19 SENATOR BOWEN: Did you get an answer to what the  
20 percentage of credits is that is, in 2001, used or was before  
21 the suspension, used in power generation activity?

22 I heard a large number.

23 MS. COY: My recollection of the question was  
24 actually not specific to 2001. And so, I had responded that I  
25 would have to go into our actual board documents, where we do  
26 have the exact numbers.





1 necessarily bad. Certainly in a volatile market, you may find  
2 hedging in order to limit risk that prices will continue to  
3 spike out of control.

4 But what happened in this market last December is  
5 yet -- and last fall -- is yet one more nail in our -- well, it  
6 speaks for itself.

7 CHAIRMAN DUNN: Let me follow up what Senator  
8 Bowen just mentioned.

9 Once they were exempted from the RECLAIM Program,  
10 from your observations, Ms. Coy, there wasn't any reason for  
11 volatility of that NOx credit market anymore; was there?

12 MS. COY: Yes, there remains the concern that the  
13 supply and demand of credits is very tight. The rest of the  
14 RECLAIM participants must face the fact that they must install  
15 control equipment that is cost-effective to meet the program  
16 end-point goals. That was the intent of this program, that  
17 control equipment be installed, and they've deferred it to  
18 almost the end of the program. And so, credits are tight, even  
19 without the power generators participating in the current  
20 market.

21 CHAIRMAN DUNN: But despite that natural  
22 tightness, because as the emissions levels decrease with passing  
23 periods, as your chart has shown, you would not have expected --  
24 and I may be repeating, and my apologies if this question was  
25 posed earlier, which I think it was -- you would not expect to  
26 see the price volatility that we have seen on the NOx credit  
27 market?

28 MS. COY: I'd answer yes to that, for the

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1 facilities that basically have a consumer product, that their  
2 actual pricing and cost and sales ratios cannot absorb beyond a  
3 certain price. And so, you end up with sellers who want to sell

4 credits, and individuals that can only pay so much for them.  
5 And so, the market equilibrates to a different norm, and that  
6 norm is the rest of the manufacturing facilities in our basin.

7 CHAIRMAN DUNN: Would not include in your  
8 description, though, the power generators?

9 MS. COY: That's correct.

10 CHAIRMAN DUNN: All right.

11 MS. Baird, back to you very quickly.

12 This filing that I read from was dated May 29,  
13 2001. Have there been subsequent filings by South Coast?

14 MS. BAIRD: Not yet. We are preparing a response  
15 to the Reliant motion that I mentioned earlier, that basically  
16 addresses the concerns that they have raised regarding -- they  
17 are making some claims that the order does not effectively allow  
18 them, or effectively incorporate the fact that there are limits  
19 on power plant operation. And we pointed out that those limits  
20 were voluntarily chosen by Reliant in order to avoid installing  
21 some pollution monitoring equipment.

22 And we also are pointing out that the -- the way  
23 the ISO has implemented the order is, we believe, consistent  
24 with the right way to implement the FERC's decision.

25 And we have not yet filed that paper, but that  
26 will be what our intent will be.

27 CHAIRMAN DUNN: Any expectation of when that will  
28 be filed?

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1 MS. BAIRD: It's our hope get it filed before  
2 Monday, at which the FERC is planning on holding a meeting which  
3 they will consider, in my understanding a wider variety of  
4 issues than just our little issue of emissions cost. But we did  
5 want --

6 CHAIRMAN DUNN: Not so little issue.

7 MS. BAIRD: We did want to have that on record  
8 prior to their proceeding on Monday.

9 CHAIRMAN DUNN: Ms. Coy, back to you. I promise  
10 I will end here eventually.

11 You mentioned before that as you've look at that  
12 NOx credit market, not only you personally, but the rest of your  
13 staff, as you've monitored it, and we've talked about some  
14 behavior that may be consistent with a design to drive up the  
15 NOx credit prices, do you have an ongoing investigation into  
16 that issue? And if so, can you share with us what exactly you  
17 are doing to further investigate that possibility?

18 MS. COY: The District has endeavored to not  
19 constrain in any way the RECLAIM trading credit market. It was  
20 set up to be an open market of the participants and open  
21 trading.

22 We, as District staff, however, are carefully  
23 evaluating whether the steps that the governing board has taken  
24 this year, and how that works with the executive orders, is  
25 adequate to stabilize the NOx credit price, while incentivizing  
26 control equipment installation to meet the program goals and  
27 make sure that the RECLAIM market is in compliance with the  
28 clean air goals that it's been designed to achieve.

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1 And so, as part of that, we're looking carefully  
2 at requesting contracts, to make certain that companies are in  
3 compliance with the new regulations, the amended regulations  
4 regarding the trading, and we're having to watch carefully what  
5 factors may come into play that affect the NOx price in a way  
6 that the governing board's amendments will not achieve the  
7 program goals.

8 So, we will have to continue to keep the  
9 governing board updated on observations having to do with both

10 the state of control equipment installation, the amount of  
11 offsetting emissions gained through the emission mitigation fee  
12 fund, as well as the dynamics that are going on in the NOx RTC  
13 prices.

14 CHAIRMAN DUNN: I'm assuming that from an  
15 historical perspective, this time period is the first time  
16 you've ever observed conduct that may suggest a pattern of  
17 manipulating the NOx prices; is that true? Have you ever seen  
18 this possibility arise before, to your recollection?

19 MS. COY: We have never seen such price swings  
20 within the NOx market before.

21 CHAIRMAN DUNN: Let me restate.  
22 First time ever within the AQMD that the  
23 discussion regarding the potential of a strategy to drive up  
24 that price has ever occurred that you're aware of?

25 MS. COY: That I'm aware of since the fall of  
26 2000, yes.

27 CHAIRMAN DUNN: Anything further?

28 MR. DRIVON: Earlier in your testimony, you 4

1 talked about these credits being traded by a generator within  
2 its own portfolio. In other words, if a generating company has  
3 a portfolio of plants, and they need to move credits from one to  
4 the other, assuming they needed to use them at all, they would  
5 do that as a zero-priced trade?

6 MS. COY: Yes, and that would be happening, for  
7 example, between the various DWP plants and previously the  
8 various AES facilities.

9 MR. DRIVON: Right.

10 So, if I'm a generator and I have two plants, and  
11 I have extra credits at Plant One, but I need them at Plant Two,  
12 that trade would be made at a zero level?

13 MS. COY: That is correct.

14 MR. DRIVON: Under the rules.

15 MS. COY: The rules actually are not specific  
16 with regard to that, but that has been the practice and the  
17 expectation since program inception.

18 MR. DRIVON: Right.

19 And you said that AES had formed some additional  
20 entities, and that they now trade credits between those entities  
21 for a price, as opposed to a zero price?

22 MS. COY: Actually, my testimony was that they  
23 have created one new entity.

24 MR. DRIVON: Okay.

25 MS. COY: And that to this point, that entity has  
26 purchased credits from other RECLAIM companies, not involving  
27 themselves, and they then sold them to AES entities at a loss,  
28 less than they paid for outside.

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1 And they have to this date on what I've seen go  
2 through, up through just a very few days ago, they had purchased  
3 credits from two facilities, Huntington Beach and Redondo Beach,  
4 two AES facilities, but they were holding those.

5 They have not to date, to my knowledge, actually  
6 sold their own credits between their own companies. However,  
7 they have purchased and held some credits.

8 MR. DRIVON: So, you have situations in which  
9 this new AES entity has both purchased credits from AES and sold  
10 credits to AES, but as yet you've not seen them buy and sell the  
11 same credits?

12 MS. COY: That's exactly correct, yes.

13 MR. DRIVON: Thank you.

14 CHAIRMAN DUNN: Senator Bowen, anything further?

15 SENATOR BOWEN: No.

16 CHAIRMAN DUNN: Ms. Coy, I think we have reached  
17 the end.

18 Ms. Baird as well, you too. Thank you very, very  
19 much for your unexpected testimony today.

20 MS. BAIRD: Thank you very much.

21 CHAIRMAN DUNN: But greatly appreciated.

22 Ms. Coy, thank you. I hope you don't mind, but  
23 there may come a time that we need to bring you back for further  
24 testimony, further clarification as we probe deeper into not  
25 only the California wholesale electricity market, but the NOx  
26 credit market as well, too. We greatly appreciate it.

27 I think we're at the end and we're through.  
28 Thanks, everyone.

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1 [Thereupon this portion of the  
2 Senate Select Committee hearing  
3 was terminated at approximately.  
4 2:35 P. M.]

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1 CERTIFICATE OF SHORTHAND REPORTER

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3 I, EVELYN J. MIZAK, a Shorthand Reporter of the State  
4 of California, do hereby certify:

5 That I am a disinterested person herein; that the  
6 foregoing transcript of the Senate Select Committee hearing,  
7 held on June 14, 2001 in Sacramento, California, was reported  
8 verbatim in shorthand by me, Evelyn J. Mizak, and thereafter  
9 transcribed into typewriting.

10 I further certify that I am not of counsel or  
11 attorney for any of the parties to said hearing, nor in any way  
12 interested in the outcome of said hearing.

13 IN WITNESS WHEREOF, I have hereunto set my hand this  
14 \_\_\_\_\_ day of \_\_\_\_\_, 2001.

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EVELYN J. MIZAK  
Shorthand Reporter

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